BEFORE

THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

DOCKET NO. 2011-317-WS

IN RE: Application of Kiawah Island Utility, Incorporated for Adjustment of Rates and Charges	)))))	**ANSWER OF KIAWAH ISLAND UTILITY, INC. TO PETITION FOR REHEARING OF KIAWAH ISLAND PROPERTY OWNERS GROUP**

Kiawah Island Utility, Inc. ("KIU" or the "Utility") files this Answer under S.C. Reg. 103-826 in response to the Petition for Rehearing filed on March 7, 2012, of intervenor Kiawah Island Property Owners Group, Inc. ("KPOG").

KPOG requests that the Public Service Commission ("PSC" or "Commission") vacate a number of findings in its Order No. 2012-98 (the "Order") ruling on KIU's application for an increase in rates and charges, and rehear this matter. Because the factual findings of the Commission are supported by substantial evidence and the Commission did not commit a legal error in its findings and conclusions, KIU respectfully submits that KPOG's Petition for Rehearing should be denied.

INTRODUCTION AND STANDARD FOR REVIEW

In its Petition KPOG recycles the arguments previously presented (1) in the hearing on November 30, 2011, (2) in its proposed order submitted January 18, 2012, (3) in its Memorandum in Support of Denial and/or Dismissal of Rate Application filed January 18, 2012, and (4) in its Motion to Overrule Hearing Officer's Denial of Motion to Compel and to Take Judicial Notice of Charleston County Tax Records dated January 23, 2012. The Commission fully considered the arguments again advanced by KPOG before issuing the Order. Nothing has changed.

Although an appeal of the Commission's Order has yet to be taken, the standard for judicial review provides guidance on the discretion granted the Commission when ruling on a rate application. The Supreme Court of South Carolina discussed this familiar standard in deciding an appeal of a previous order on a rate application submitted by KIU that was challenged by KPOG:

> "The PSC is considered the 'expert' designated by the legislature to make policy determinations regarding utility rates; thus, the role of a court reviewing such decisions is very limited." Therefore, the party challenging a PSC order must establish that (1) the PSC decision is not supported by substantial evidence and (2) the decision is clearly erroneous in light of the substantial evidence in the record.

Kiawah Property Owners Group v. Public Service Commission of South Carolina 359 S.C. 105, 109, 597 S.E.2d 145, 147 (2004) (internal citations omitted).

Substantial evidence means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. Porter v. South Carolina Service Commission, 333 S.C. 12, 23, 507 S.E.2d 328, 324 (1998). Under the substantial evidence test a finding upon which reasonable men might differ will not be set aside. Lark v. Bi-Lo, Inc., 276 S.C. 130, 137, 276 S.E.2d 304, 307 (1981). Further, as the fact finder, the Commission is entitled to make its own determinations of the credibility of the witnesses and the weight to be given to particular evidence including experts, as noted by the Commission in the Order.

I. The Commission's Determinations with Respect to KIU's Purchase in 2008 from KRA of the Down Island Storage Parcel and Purchase in 2009 of the Sewer Treatment Parcel Are Fully Supported by the Proof.

The Supreme Court of South Carolina's decision in Hilton Head Plantation Utilities, Inc. v. Public Service Commission of South Carolina, 312 S.C. 448, 441 S.E.2d 321 (1994), relied upon by KPOG (Petition for Rehearing, p. 6), does not support KPOG's contention that all expenses associated with a related party transaction must be disallowed. Instead, Hilton Head Plantation Utilities, Inc. imposed the burden on a utility to demonstrate the reasonableness and fairness of related party transactions, which KIU easily met in this instance. The record and law fully support the Commission's allowance of expenses in the test year, if any, associated with KIU's purchase of these two parcels in 2008 and 2009 that were previously leased. These two parcels containing critical plant facilities have been located on them for more than 15 years.

KPOG asserts that the Commission should disallow any expenses associated with the purchase of the land alone for the Down Island Storage Facility in 2008 and the Sewer Treatment Parcel in 2009 on the grounds that KIU did not separately obtain PSC approval for each sale. KPOG relies on the Commission's disallowance of expenses associated with the purchase of the Cougar Island parcel in 2010 for Aquifer Storage and Recovery ("ASR").

The circumstances surrounding the purchase of the land for the Down Island Storage Tract and Sewage Treatment Tract differ significantly from the Cougar Island ASR site. Both parcels were leased by KRA to KIU to allow KIU to install necessary facilities for the operation of the Utility in the mid-1990s. (Tr. Pp.173-174). These two leases and the expenses associated with them were first put under scrutiny as part of KIU's 1996 rate application. Order No. 97-4, p. 16; Order No. 97-151, p. 9. Admonishing KIU for its failure to obtain pre-approval of the two leases, the Commission allowed the rental expenses since KIU demonstrated the amount, based on an independent appraisal, was reasonable and the land was used and useful to the Utility's operations.

The Commission reaffirmed its allowance of these rental expenses upon its decision on remand. Order No. 2000-713, pp. 15-17.

KIU's purchase of these two parcels accomplished what KPOG argued in this prior rate proceeding should have occurred. KPOG previously based its opposition to the lease expenses on its argument that the Utility should buy, rather than lease, land on which it constructed facilities. As explained by witness Heyboer in this proceeding, KIU did not have the funds on hand or the ability to borrow in the mid-1990s and was required to lease instead. (Tr. pp. 160-161). The two leases were amended to include an option to purchase for the market value of the land alone. (Tr. pp. 173-174). The Lease Amendment required that the purchase price be determined by independent appraisals. (Tr. pp. 159-162, 173-174). When the options were exercised in 2008 and 2009, the purchase price for these two sales was determined by separate independent appraisals of the value of the land alone. Id. With respect to KPOG's challenge as to the timing of the purchases, Heyboer testified the timing was favorable to KIU since the real estate values were down in 2008 and 2009. (Tr. pp. 183-184). The record is undisputed that important plant in service for the operation of the Utility that is used and useful is located on the two tracts. All these facts fully support the Commission's findings and distinguish the acquisition of these two previously leased parcels from KIU's 2010 purchase of the Cougar Island site for ASR.

KIU would also point out the Commission allowed the lease expenses for these two sites in the test year for the two intervening rate applications filed in 1998 and 2001. (Order No. 99-216; Order No. 2002-285, pp. 30-31).

S.C. Regs. 103-541 and 103-743 do not specify that contracts entered without prior approval of the Commission are *per se* invalid regardless of their reasonableness or the contracting utility's essential need for the services or property subject to the contract. The two leases that were amended to grant an option to purchase had previously been reviewed in detail and, as stated, the expenses associated with them were allowed in the test year in all KIU's rate applications after the entry of the leases.

As stated by the Commission in the Order, the guiding determination in reviewing transactions between a utility an affiliate is whether the utility established the reasonableness and propriety of the services rendered or property purchased as well as the reasonableness of their cost. Order, p. 21. KIU met this burden of proof as to the purchase of these two parcels through the testimony of witnesses Heyboer, Dennis, and Guastella. KPOG did not offer any evidence that the purchase price of the land was excessive or unreasonable.

KPOG is incorrect in arguing there is no proof that the purchase price for each of the two parcels was determined by independent appraisal. KPOG makes this contention because KIU did not introduce the two appraisals as exhibits. The evidence in this case consists of the admitted exhibits *and the testimony*. Witness Heyboer's testimony that the purchase price of the land for each of the two parcels that were under lease was determined by independent appraisals obtained by KIU is ample evidence of the method used to determine the purchase price.

II. The Record Establishes the Reasonableness and Necessity of KIU's Loan with RBC Bank. There is Substantial Evidence to Support the Allowance of Interest Expenses Associated with the RBC loan in the Test Year.

KPOG misunderstands the credit relationship between KIU and RBC Bank, and imposes an incorrect reading of the security instruments. The evidence does not support any modification of the Order based on KIU's arm's length banking relationship with RBC.

Witness Heyboer testified at length to KIU's credit facility with RBC Bank. KIU's previous lender was Bank of America. Heyboer testified that KIU refinanced with RBC to pay off its Bank of America notes and consolidate its debt. (Tr. pp.193-194). KPOG argues that KIU entered "onerous contractual agreements and loan provisions with RBC." Petition, p. 6. KPOG apparently basis its contention that the loan arrangement was "onerous" on terms of an interest swap agreement entered to protect KIU against rising interest rates and the standard provisions granting a security interest in the stock and assets of KIU to RBC.

Heyboer testified that KIU entered the interest swap contract to place a ceiling or cap on the potential increase in the variable interest rate of the RBC loan. (Tr. pp. 186-187, 189). The swap "in essence, turned the variable rate loan into a fixed rate loan at 5.45 per cent." (Tr. p. 186). This testimony establishes the reasonable purpose for entering the interest rate swap agreement. Heyboer also testified that the interest rate swap terminated without any payment by KIU to RBC. (Tr. p. 189, 208-209). There were no expenses in the test year associated with the interest rate swap agreement. But, even if there had been a payment, Heyboer's testimony would have provided a reasonable basis for allowing it.

KPOG's argument is not supported by credible, competent proof that the transaction was unreasonable or harmed KIU in some manner, which it did not.

Turning to the terms of the loan, Heyboer testified that the terms were standard for loans of this nature. (Tr. pp. 190). The loan documents themselves (Stipulated Exhibit 3, Tabs 17, 18, and 19) show that they are standard forms used by conventional commercial lenders. While KPOG takes issue with these standard terms, KPOG put forward no proof that these terms were anything other than the standard form provisions or that this favorable loan to pay off Bank of America could have been obtained and closed on more favorable terms.

As pointed out in previous filings in this case, KPOG misunderstands the cross-default provision under the RBC loan documents. The form loan document specifies that KIU's default also constitutes a default as to any loans to its subsidiaries. (Exhibit 3, Tab 14, p. 23, 13(K)). KIU has no subsidiary. Kiawah Resort Associates, LP, the parent of KIU, is not a party to the loan agreement and is not a subsidiary of KIU. A hypothetical default by KRA on its separate loan obligations with other lenders has no effect on KIU.

KPOG mistakenly suggests that KIU owes RBC $15 million. Petition, p. 8. As witness Heyboer testified, the balance of the loan is approximately $8.3 million. It is common practice to have a mortgage in a higher amount that would allow future advances. (Tr. p. 158).

In conclusion, the evidence does not demonstrate that the loan terms between KIU and RBC are "oppressive and onerous." Petition, p. 8. The proof from witness Heyboer is that these were standard terms imposed by the lender, RBC, for a favorable loan that consolidated KIU's bank debt and took out Bank of America. (Tr. pp. 193-194). As

Heyboer testified, very little of the balance of the amount drawn on the loan related to KIU's purchases in 2008 and 2009. (Tr. p. 161).

Moreover, as stated by the Commission in the Order, the Commission does not have authority and jurisdiction to alter the loan documents or enter relief against RBC which is not a party to this proceeding. Kiawah Property Owners Group v. Public Service Commission of South Carolina, 357 S.C. 232, 593 S.E.2d 148 (2004). Finally, as stated by our Supreme Court in deciding a previous appeal by KPOG that attacked the terms of the prior loans with Bank of America, "the argument that the cross-collateralized loan agreement will harm rate payers in the future does not present a justiciable controversy." 597 S.E.2d 149. Again in this case, the possible consequences from RBC's exercise of its rights under the loan documents in the highly unlikely event of a default by KIU is entirely speculative and does not present a justiciable issue for determination by the Commission.[1]

III. The Utility Service Agreement Entered between KIU and KRA in 1997 is Irrelevant.

In 1997 KIU and KRA entered a Utility Service Agreement ("USA") that set forth reciprocal obligations between the two entities. This USA replaced a previous Utilities Service Agreement entered between KIU and KRA in 1994. KIU did not seek approval in this rate proceeding of any expense associated with the 1997 USA since, among other reasons, the 1997 USA did not impose any expenses on KIU.

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[1] Banks typically do not implement boiler plate self-help provisions such as those singled out by KPOG. In most instances they seek the approval of a court to implement them. In any event, in the remote hypothetical possibility of both a default and RBC's unilateral exercise of its rights, the Commission would have complete jurisdiction over the operation of the Utility that is reserved to it by statute.

Nonetheless, KPOG argues that the Utility was prejudiced because the 1997 USA stated that KRA would sell the property to KIU at fair market value. As attested by witness Guastella (Tr. p. 244) and held by the Commission in its Order (Order, p. 17) there is no regulation or requirement that the parent of a public utility donate property or sell property at less than fair market value. KPOG appears to argue that the sales price should be governed by the 1994 Utility Service Agreement that specified that property would be sold by KRA to KIU at 50% of fair market value. However, that agreement was terminated.[2]

IV. The Audited Financial Statements Do Not Provide a Basis for Altering the Order.

In its Petition KPOG randomly selects a few items from KIU's audited financial statements suggesting that they are suspicious or irregular. KPOG failed to put forward confident, credible testimony that these entries are incorrect or that they affect the test year revenues and expenses allowed by the Commission.

KIU files annual financial reports with the Commission. These annual reports are tied to the audited financial statements of KIU. ORS fully reviewed those reports and the back-up documentation during its exhaustive financial audit of KIU. KPOG's attack on ORS is unwarranted. ORS closely scrutinized all expenses of KIU associated with the test year and made adjustments that KIU accepted for purposes of reducing the matters at issue in this proceeding.

[2] KPOG meets itself coming and going on this argument. In every instance but this one, KPOG argues that contracts that were not approved ahead of time by the PSC are invalid. KPOG makes a special exception for the terminated 1994 Utility Service Agreement since it likes its terms, regardless of prior pre-approval.

Two corrections to KPOG's contentions are in order. There is nothing "interesting and unusual," as intimated by KPOG, about KIU's changing auditing firms in the last ten years. (Petition, p. 13). The names changed but the auditors did not. The accounting firm of Finch Hamilton (first firm) merged with the accounting firm of Webster Rogers (second firm).

Second, KPOG singles out a footnote to the 2010 audited financials that land in the amount of $1,264,450 was exchanged for an addition to a note payable. (Petition, P. 13; Hearing Exh. 3, Tab 10, p. 6). This note payable was not a note to KRA but rather an addition to the amount under the note payable to RBC.

The focus in reviewing a rate application is the revenues and expenses in the test year. The audited financial statements did not change either the revenues or expenses for the test year that were ultimately allowed by the Commission. The Commission fully considered the testimony of the witnesses and other evidence in making its findings concerning adjustments to the test year revenues and expenses that are amply supported by the evidence.

V. The Commission is not Obligated to Adopt the Testimony of KPOG's Expert Witness William Rogers as KPOG Argues.

As stated in its Order, the Commission found that the operating margin approach was the more suitable approach to the determination of KIU's application and that a reasonable and fair operating margin was 13.75%. Witnesses Guastella and Majewski testified to this effect. The Commission set forth ample justification, supported by the evidence, for not adopting this operating margin which was higher than the operating margin recommended by Rogers.

The Commission fully weighed the testimony as to an appropriate operating margin. As previously stated and noted by the Commission in its Order, it was entitled to determine what weight should be given to the testimony of the witnesses including the experts. Exercising its discretion to weigh the evidence, the Commission based its operating margin determination on the testimony of the ORS witnesses as well as witness John F. Guastella. These witnesses' testimony fully supports the Commission's findings and conclusions as to a reasonable operating margin.

VI. The Commission has the Authority to Determine the Weight It Gives to the Comment Letters. These Comment Letters do not Change the Financial Analysis on Which the Commission's Determination was based.

KPOG argues that the sentiments against a rate increase expressed by customers who spoke at the night hearing or submitted letters should control the outcome of this proceeding. These letters and comments were mostly general in nature.

To the extent the letters and comments were specific as to the amount of increase requested, several incorrectly asserted that KIU was seeking a 39% increase in rates. KIU withdrew its request for the phase 2 increase to water rates to pay for the secondary line. The 39% increase to water rates would have occurred only if the secondary line were constructed and the rates approved thereafter. The percentage increase to water rates is approximately half of that stated by the opponents. Many of the comments featured by KPOG in its Petition asserted that the ratepayers should not bear the cost of the second water line if its purpose was to serve new development. Even though witness Dennis testified that KIU had adequate capacity to serve build out without the second supply line, the issue was rendered irrelevant when KIU withdrew the portion of its application seeking the phase 2 increase.

None of the comments were directed to the revenues and expenses in the test year. Those comments have little pertinence to the Commission's determinations in the Order which are fully supported by the record.

VII. The Commission's Ruling Sustaining the Hearing Officers' Denial of the Motion to Compel Should Be Sustained.

As set forth in KIU's Memorandum in Opposition to KPOG's Motion to Compel and its Memorandum in Opposition to KPOG's Motion to Overrule the Hearing Officer, the Commission had several valid legal grounds for upholding the hearing officer's denial of KPOG's Motion to Compel. KPOG's interrogatories violated the regulation governing pre-hearing interrogatories that requires they be served more than ten days before the scheduled hearing. Additionally, contrary to KPOG's argument, the evidentiary record did not remain open after the final hearing except for the one or two items requested by the Commission. As for KPOG's argument of judicial notice, S.C. Reg. 103-846(C) controls over the South Carolina Rules of Evidence in these regulatory proceedings. As found by the Hearing Officer, KPOG did not meet the requirements of this regulation for taking notice of judicially cognizable facts. Finally, as noted in Plaintiff's Opposition to KPOG's Motion to Overrule the Hearing Officer, two of the three records from the RMC Office do not involve the properties that were purchased by KIU from KRA.

VIII. Conclusion

For the foregoing reasons, the Commission's findings are fully sustained by the evidence and its conclusions are not erroneous as a matter of law. The Utility respectfully requests that the Commission deny KPOG's Petition for Rehearing.

Respectfully submitted
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